CHAPTER 1: OVERVIEW OF RESEARCH PROJECT

1.1 INTRODUCTION

Share buybacks or also known as “share repurchase”, happen when a company buying back its share from the marketplace, reducing the number of share outstanding. One can think that of share buyback as when company investing in itself or using cash to buy its own shares. The company may retire the shares or keep them as treasury stock, make it available for re-issuance. In US and UK the repurchased share are cancelled immediately after a particular buybacks program. Practically, share buyback can be undertaken by way of tender offer and open market repurchase. Normally, firms took tender offer repurchase when they plan to buy a large proportion of its stock, greater than 10 per cent. Firms that intend to buy only small percentage of the outstanding stock can do so in such process called open market repurchases.

Among the countries which allow share buyback by companies, US have the longest history. Share buybacks had appeared in the U.S. in the late 1960s and grew strongly as a popular means of returning cash to shareholders by mid-1980s. Outside the American continent, share buybacks started in the U.K. in early 1980s. The period between 1995 and 2000 witnessed increase in share buybacks activity in many of European countries. In addition, share buybacks were permitted both in France and Germany in 1998. As in Europe, share buybacks have been authorised in Asian countries by late 1990s where it started in Japan by 1995 followed by Malaysia in 1997, then Singapore and Hong Kong in 1998 and Taiwan in year 2000.

In this 21st century, share buybacks activities have shown growing increase in many of the world economy. During 1980-2000, the expenditure of stock repurchases grew at 28.1 per cent of average annual rate, while expenditure on dividends only grew at 26.1 per cent (Grullon and Michaely, 2000). They argued that many industry firms are likely to spent more money on share buybacks. Rau and Vermaelen (2002) noticed that during 1985-1999, share buybacks were particularly accepted and many firms have earned positive abnormal returns in the long-term. In addition, they argued that the growth in the share buybacks has been much more than the dividends in the last 20 years.

While share buybacks programme is gaining its popularity as an alternative way to dividend to return excess cash to shareholders, there is a need to study the motivations behind such activity among corporation. Much of previous literature revealed the motivations of share buybacks in which most cited reason was aimed to maximized shareholders value which is in line with good corporate governance principles. Those principles have led the Government via the national stock exchange to legalize share buybacks programme with the objective to achieve more flexibility in financial management of public listed companies and make the national stock exchange more competitive (Emmanuel, 2006). In other words, share buybacks should not be undertake merely to improve financial ratios (i.e. EPS) of the firm rather than it should aims to maximize of shareholders' value.

This chapter provides an overview of the research project undertaken to examine the determinants of corporate share buybacks by comparing buybacks and non-buybacks companies (repurchase versus dividend). The details of the chapter are organized as follows: Section 1.2 discusses the background. Section 1.3 highlights the methodology and research hypotheses and finally, Section 1.4 explains organisation of the study.

1.2 BACKGROUND

The proponents of buybacks activity well supported the programme with reason that it will result in a positive outcome both for company and remaining shareholders. This argument was well supported by several capital market researches (Harris and Ramsay, 1995; Christianto *et al.*, 1998) that documents a positive wealth effect on the announcement of buy-back. In contrast, Ferguson (1995) notes that manager perceives that a buybacks is seen by shareholders as a sign of weak management or that the management team is unable to allocate positive net present value of future investment. This assumes that shareholders would prefer the investment of any surplus or "free cash flow" rather than receiving a benefit in form of return on investment. Moreover, numerous motivations for buyback are reported in the financial press, but to large degree these motivations remain unverified.

According to Washer (1998) there exist three types of empirical studies concerning share buybacks. The first type examines the announcement period returns for firms initiating a buybacks program. Ikenberry and Vermaelen (1996) analysed the cumulative abnormal return (CAR) for 892 firms announcing open market repurchase plan and regress CAR on the fraction of shares authorised for repurchase, the standard deviation of the of the firm's total return and the firm's R squared form the market model. The result shows that these three variables explain much of the variability in the announcement period return among firms and conclude that creating a repurchase option is an important motivation for open market repurchase.

The second type of study analysed the subsequent performance of firms announcing share buybacks. Ikenberry, Lakonishok, and Vermaeln (1995) found that firms that announcing an open market repurchase and have high book-to-market value ratios, have a 4-year buy-and-hold abnormal return of 45 per cent. They conclude that the market inefficiently processed information related to open market repurchase announcement during 1980-1990 period and suggest that an important motivation for announcing an open market repurchase program is undervaluation.

The third type of study compares repurchasing firms to non-repurchasing firms. Finnerty (1994) compares firms whose numbers of shares decrease during the year (buy backs firms) and to firms whose number of shares increased during the year (issuing firms). He found that prior to repurchase; repurchasing firms use less financial leverage and have higher dividend yields than issuing firms. The present study employ the third type of study to compare repurchasing firms and non-repurchasing firms in determining the motivating factors that influence some firms to repurchase as compared to those dividend paying firms.

1.2.1 Motivations of share buybacks

The motivations of share buybacks programme have receive great attention from scholars, financial economists and business journalists, as well as practitioners. Firms buy back their share for a multitude of reasons which includes to increase their leverage ratio (Bagwell and Shoven, 1988), to fund employee and management stock options (Fenn and liang, 2001; Kahle, 2002), to prevent hostile take-over attempts (Bagwell, 1991; Billet and Xue, 2007), to mimic competitors (Massa, Rehman, and Vermaelen, 2007), to distribute excess cash flow(Jensen, 1996) and to signal undervaluation due to asymmetric information between managers and shareholders (Stephen and Weisbach,1998; Vermaelen, 1981). While these motivations are not mutually exclusive, some are arguably more important to management and to investors than others. Grullon and Michaely (2004) identified that reducing agency problems associated with free cash flow and signalling undervaluation as the two major theoretical reasons for share buybacks. Brav *et al.*,(2005) provides empirical evidence in supporting these motivations.

In 1999, the Financial Executives International Research Foundation (FERF) undertook a poll of its member in order to investigate the motivations for share repurchase by studying 200 companies who had undertaken share buybacks programmes. The finding revealed that 39 per cent of the respondents instituted a share buybacks program in order to improve their earning per share, 28 per cent said that their companies were using share buybacks as a way to distribute cash to shareholders, 21 per cent reported that their companies were trying to reduce the cost of employee stock option plan, and 12 per cent noted that adjusting capital structure was the main reason for their buybacks.

That research provide support to the theory of share buybacks motivations which among other includes (1) to increase share price, in which this is the most popular strategy that management adopt when it believes that the company's stock is undervalued by market analyst, (2) to rationalize the company's capital structure where share buybacks allows the company to sustain higher debt-to-equity ratio, (3) to prevent dilution of earnings in which share buybacks able to enhance firm's earning per share (EPS) or conversely prevent decrease in EPS due to employee stock option scheme, (4) to substitute share buybacks for cash dividend where capital may be taxed at lower rate (to the extent of tax-exempted depends on country tax treatment) and provides shareholders with some tax advantage, and finally (5) to deploy excess cash flow particularly when company has met its capital investment needs.

As mentioned earlier, share buyback is not just distributing cash to shareholders rather the consequences is also complex. Share buyback can either create or destroy value, depending on how the programme affects investor perceptions about the firm's long-term prospect. Therefore, Badrinath, Varaiya and Ferling (2001) suggested that share buybacks should be undertake in two circumstances conditions: (1) when the companies have excess debt capacity, and the supply of funds exceeds the demands, and (2) when the firms are under performing, in term of profitability and sales growth rate, relative to their industry's averages. In contrast, share buybacks should be avoided under these two conditions: (1) when firms are over-leveraged and sales growth rate exceed industry average, and (2) when both their profitability and sales growth rates exceed industry average. In addition, they suggested that a firm with excellent growth should clearly articulate its reasons for share repurchase because there is an argument that the capital committed to buyback should be better employed elsewhere. This is because, a clearly expressed rationale of share buyback program is critical to avoid any misinterpreting information by investors as negative signal.

1.2.2 Repurchasing versus non-repurchasing firms

Share buybacks are essentially equivalent to dividend if taxes and transaction cost are not taken into account. Both should convey the same message to shareholders that the company has generated a sizeable cash flow. The major different is that share buybacks reduced number of share outstanding, capital structure as well as EPS of the firm.

Young (1969) compares financial, operating and security market conditions of repurchasing firms and non-repurchasing firms. He finds no distinct in liquidity position between the two groups, but the results revealed that repurchasing firms typically use less financial leverage and have greater debt service ability prior to the buyback. Young also discovers that repurchasing firms have relatively lower total asset growth rate and suggest that they have relatively fewer investment and therefore repurchase stock with their excess cash. In addition, these two groups are different in sales growth, operating income growth prior and during the year of repurchase. Repurchasing firms have lower growth rates in sales and operating income making them desperate to announce buybacks program in hopes to maintain their earnings per share.

Norgaard and Norgaard (1974) found repurchasing firms have lower price/earnings ratios, higher book-to-market ratios, and higher dividend yields. These firms also hold less cash but have higher inventory and/or receivables balances. In contrast to Young (1969), they found that repurchasing firms use more debt than non-repurchasing firms. They conclude repurchasing firms are inferior to non-repurchasing firms and suggests the managers to re-examine the repurchase decision in light of both theory and practice of share buyback program.

Finnerty (1975) found that firms issuing equity generally have more financial leverage and lower dividends than repurchasing firms. These results suggest that repurchasing firms have relatively fewer investments in future. Guffey and Schneider (2004) complements the work of Medury *et al.* (1992) by introduce the tax and leverage motive based on changes in the tax law (Tax Reform Act 1986) which have not been addressed in the literature. The result shows that buybacks firms are larger, less indebted, more profitable, and experienced greater growth than the non-repurchasing firm.

1.2.3 Share buybacks in Malaysia

Share buybacks is a recent phenomenon in the Malaysian capital market. It has only been allowed in 1997 as a response to the currency crisis when the capital markets were hit rock bottom. The 1997 Asian financial crisis adversely affect Malaysian Ringgit and led to 30 per cent devaluation of the currency against US dollar while the Kuala Lumpur Composite Index (KLCI) dropped 58 per cent from its high during that year. The Government and capital market leaders try to rejuvenate investors' confidence by introducing share buyback regime and hence shore up the share price.

Finally, on 1st October 1997 share buyback was legalized under Malaysian Companies Act through the enactment of Section 67A where all public listed companies were allowed to repurchase their own share through proper application. However, only open market share buyback was authorised in Malaysian jurisdiction. Being a public listed company (PLC) of Kuala Lumpur Stock Exchange (currently known as Bursa Malaysia), the companies are subject to comply with the rules and regulations set out in the Bursa Malaysia Listing Requirements. Among others, the buyback should have approval from the shareholders and the amount of buyback should not exceeding 10 per cent of the issued share capital and the funding should come from the excess cash flow or retained earnings or distributable profits. However, there is no actual as to how many share can be bought back on a single trading day. Furthermore, those listed companies should report all transaction of the buyback into the financial statement as stipulated under Malaysian Accounting Standard Board in April 1999 via its circular of “share buyback accounting disclosure”.

About ten years after 1997 Asian Financial Crisis, share buybacks activity among Malaysian corporate gain back its popularity. It is observed that, many of the companies announced share buybacks programme in late 2008. Recent financial crisis shown that share buyback became a popular tool among Malaysian corporate. Stock market analysts posits that many firms were practise share buybacks during the peak of global economic crisis in the latter part of 2008 and early of 2009. Generally, the companies would buy back its share to boost the stock price if it perceived their security is undervalued. Share buy backs could also be an indication of planned corporate exercise by a company. In

SECTOR	YEAR									
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Consumer Products	5	4	4	7	10	7	14	16	23	23
Industrial Products	2	2	8	8	17	19	39	51	59	70

fact, there are companies that announce repurchase and at the same time pay dividend on yearly basis.

Table 1.1: Sector Classification of repurchase companies from year 1999 to 2008

Construction	0	1	2	2	2	1	4	5	7	13
Trading / Service	2	2	4	4	12	16	32	36	30	41
Finance	0	2	2	3	5	6	9	7	5	12
Infrastructure	0	1	1	1	1	1	1	1	1	2
Property	0	0	5	5	12	16	21	21	16	20
Plantation	2	1	1	2	2	2	3	5	4	8
Technology	1	1	2	0	0	2	4	3	5	14
TOTAL	**12**	**14**	**29**	**32**	**61**	**70**	**127**	**145**	**150**	**203**

Table 1.1 in previous page shows the sector-wise classification of buybacks companies from 1999 to 2008. The data from 1999 to 2006 was adapted from Ramakrishnan, Ravindran & Ganesan (2007) while the data from 2007 to 2008 was compiled from Bloomberg data terminal and Bursa Malaysia web site. It is observed that Industrial Products sector was the major player of buybacks programme. According to Ramakrishnan, Ravindran & Ganesan (2007) found that information gap between managers and investors are wider in industrial sector as compared to the other sector. They argued that this might be due to uncertainty in manufacturing environment, advent of technological innovations and competitive nature of the industrial sector. Therefore, the information divide between insiders (managers) and outsiders (shareholders) seem to be greater than other sectors. Thus, share buybacks was undertaken to signal information in order to retain investors' faith and confidence. In addition to that, it is understood that the industrial sectors is the major contributors in share buybacks activity because industrial sector represent about 27 per cent of total listed companies. In contrast, trading/service sector also among the larger contributor of buybacks activity in which it represent about 25 per cent of total population of listed companies. Overall, it is observed that buybacks activity showing incremental trend among all sector together with increasing number of repurchase companies.

Therefore, the objective of this study is to investigate the increasing popularity of share buybacks in Malaysia and to develop an understanding of the motivations behind the decision to repurchase. In addition, this study also consider both repurchasing and non-repurchasing firms in identify more meaningful motives of share buybacks.

1.2.4 Research problem

Why do firms repurchase stock? The most general answer, and the one that shareholders hope, is that firms undertake share buybacks in order to increase shareholders wealth, which is regarded as a good corporate governance practice. Several approaches have been taken to determine the specific motivations for share buybacks. One approach is simply surveying managers' motivations for a repurchase program. For example, Baker *et al.,* (2003) and Dixon *et al.,*(2008) examines such motives by way of questionnaire to the financial executives in order to access their real motive of share buybacks program. The problem with this approach is that, the manager may not give truthful answer (Washer, 1998).

Another approach is to infer motivations by studying firms that announce repurchase programs. But, this approach is subject to that many firms fail to repurchase as many as shares they announce. Third approach which is used infrequently is to analyse firms that actually repurchase stock in order to understand the motive of share buyback (Washer, 1998). The current study focus on the total amount of cash distributes to shareholders from the buybacks programme and the factors explain the variability of cash distributions (repurchase versus dividend) among firms.

Therefore, this study attempts to answer the following questions:

1. Which of the developed hypothesis regarding repurchases relatively explains the most about share buybacks behaviour?

2. Does repurchasing firms are significantly different from non-repurchasing firms?

1.2.5 Motivation for this study

Based on my observations, there exists very limited study on share buybacks in Malaysian environment particularly in determining the motivations of such program. Akma(2006) examined the motivations of share buybacks from period of 1999 -2005 and found that Malaysian companies announce share buyback to support undervaluation and to improve the operating performance. Prior to that, Nasruddin and Angappan (2003) explored the stated motivations of buy backs companies between 1999 and 2002. This exploratory study aims to examine the stated motivations of repurchasing firms by compiling all announcements made via firms' circular to shareholders. The result shows that, out of the nine identified motivations of share buybacks, four are hardly stated by the companies. These include distributing cash, issue stock under employee share option scheme, change in capital structure, and anti-takeover measure. While the five widely-stated motivations are to pay stock dividend, investment opportunity, stabilise the share price, use surplus cash and increase shareholders return by improving the earnings per share ratio.

Therefore, I wish to contribute on this area by extending previous two researches by examining the differences between repurchasing and non-repurchasing firms. In fact, this study indirectly identifies the differences of the two groups based on the proxies of their financial characteristic. Therefore, this study is expected to contribute meaningful determinants of corporate share buybacks. In, addition, the current study is the first of its kind in Malaysia (as evidenced from to-date access from online databases and publication) which researches the hypothesised motivations of shares buybacks in comparison between repurchasing and non-repurchasing firms.

CHAPTER 2: LITERATURE REVIEW

2.1 INTRODUCTION